GREAT-WEST CAPITAL MANAGEMENT, LLC (GWCM) RESEARCH NOTE

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GREAT-WEST FINANCIAL

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WHY ACTIVE MANAGEMENT REMAINS RELEVANT

When constructing an investment portfolio, whether it's a personal retirement account or a $1 billion mutual fund portfolio, an important decision investors must make is whether to select active or passive management in each asset class. In order for an investor to choose active management, he or she needs to believe active management can outperform its assigned index, and that they can identify such a manager. If the individual doesn't believe both of these statements are likely, he or she will default into passively managed strategies which are less expensive and offer index-like returns, less their fund expenses.

Over the past five years, passive strategies have won over the hearts and minds of investors relative to their actively managed counterparts. According to Morningstar® data, passive funds have received greater net inflows than active funds in each of the past five calendar years, resulting in $1.1 trillion flow disparity between the two categories.[1] However, the decision may not be as cut and dry as recent flow data suggests. Great-West Capital Management (GWCM) believes that there is cyclicality associated to when active management can add value, that active managers may offer protection during market downturns, and that successfully selecting skilled managers can add meaningful value to an investor's portfolio over the long run.

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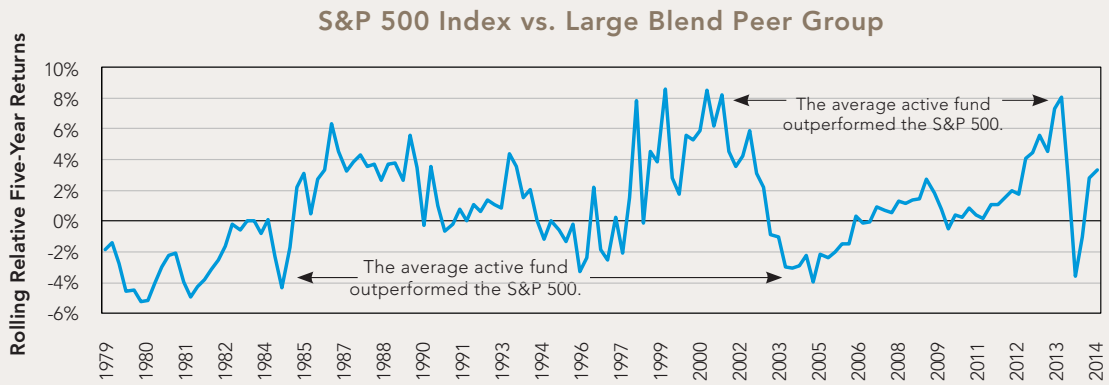
For the sake of simplicity, we'll use the S&P 500® Index (S&P 500) as the passively managed strategy and Morningstar's large blend peer group as the actively managed strategy to compare performance. The chart below shows the S&P 500's return relative to the Morningstar large blend peer group's return over rolling five-year periods since 1975. Positive values can be interpreted as periods in which passive management was in favor, while negative values can be interpreted as periods in which active management outperformed passive management. From this chart, one can see that the S&P 500 doesn't always outperform the actively managed Morningstar large blend peer group. There are many periods in which the average active manager significantly outperforms the S&P 500 — even after accounting for fund expenses.



Past performance is no guarantee of future results. A benchmark index is not actively managed, does not have a defined investment objective, and does not incur fees or expenses. Therefore, performance of a fund will generally be less than its benchmark index. You cannot invest directly in a benchmark index.

1 Source: Morningstar® Direct℠ - 1/1/2010 through 12/31/2014 Net-Flows to United States Open-End Mutual Funds, Exchange Traded Funds, and Money Market Funds, not including Fund of Funds, or Funds that are no longer in existence.

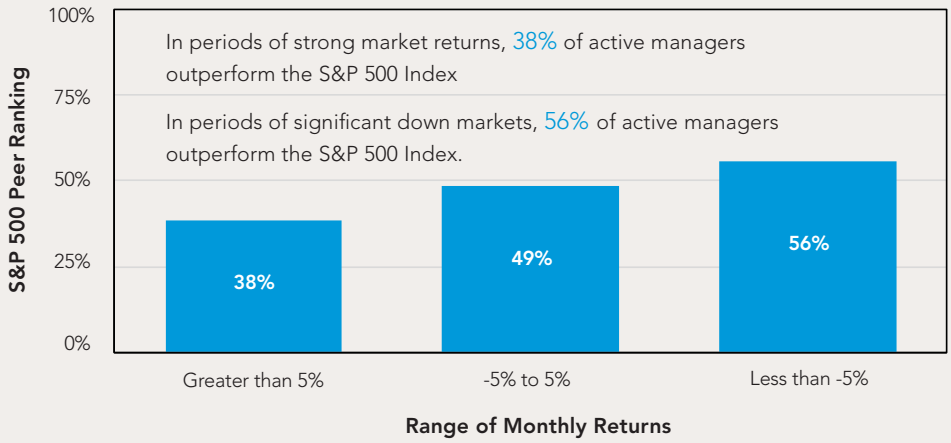
After seeing how active and passive strategies alternate in terms of when one outperforms the other, we can try to identify market conditions that may influence this relationship. One factor that appears to impact this is the absolute direction of market returns. The chart below displays the S&P 500 as if it were a fund within the large blend peer group. We can then determine its average percentile rank within the large blend category for each month and find an average ranking for the index based on the direction and magnitude of returns. Over the past 40 years, the S&P 500 has averaged a peer ranking of 38%, meaning that it has outperformed 62% of the actively managed funds in the category when monthly returns of the index have exceeded 5%. However, when monthly index returns surpass negative 5%, it has an average peer ranking of only 56%, meaning that the majority of active funds outperform the S&P 500 during these downturns. This chart shows that when equity markets are strong, it is difficult for the average active manager to add value. However, when markets pull back, the average active manager is able to add value over its benchmark.

What may contribute to the trend of active managers outperforming passively managed funds in down markets? When interviewing active portfolio management teams, we often find that most try to identify stocks with some mix of strong fundamentals, growth prospects and/or attractive valuations.

Consider the alternative: Few active managers target, or admit to targeting, companies with suspect balance sheets, poor growth opportunities or stretched valuations. In our experience, these points of emphasis have historically led to high-quality biases within funds. Therefore, it would make sense that an active managers' fund performance holds up during market downturns because these sound businesses are more likely to survive, or even thrive, during periods of economic contraction.

Additionally, the S&P 500 and many other indexes are market-cap weighted, which means that their underlying allocations are determined by the market capitalization of all of the underlying stocks. In broad terms, the larger the company, the larger the weight it will have within the index. However, this allocation style can result in an overweight allocation to overvalued stocks. While active managers try to avoid holding the most overvalued names, index funds have no such luxury as they must replicate the allocations of their underlying benchmark. As these overvalued names increase in value to unreasonably high levels, many active managers will exit their positions. As long as this type of irrational buying exists in the marketplace, the passively managed funds can outperform their active counterparts. Ultimately, when these stocks are recognized by the market as overvalued and the bubble pops, the passively managed funds can experience significant losses. During these selloffs, active managers who got out of the way, so to speak, can add significant value.

Active Management has Added Value During Down Markets, But Struggled During Strong Rallies



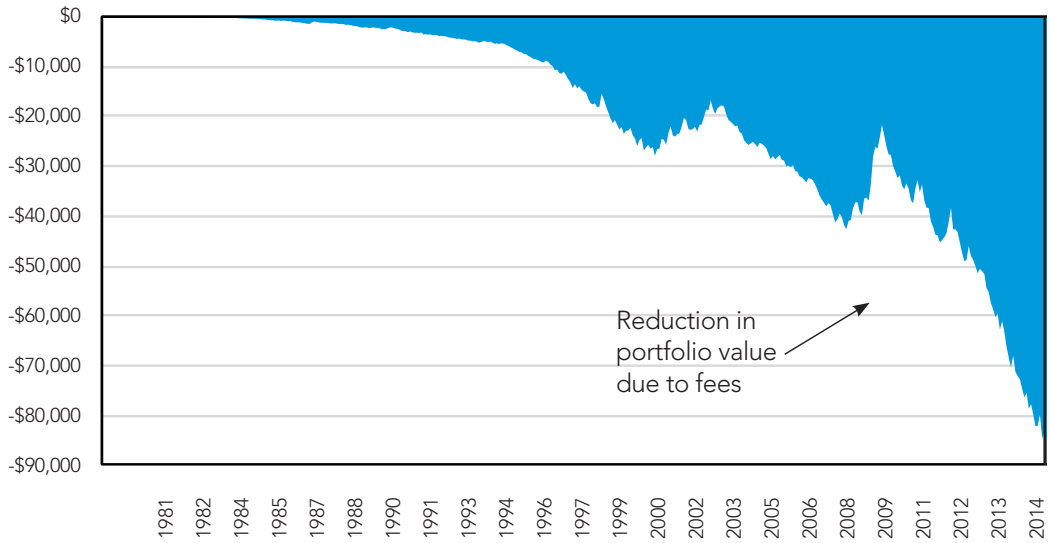
Source: Morningstar® Direct℠; GWCM analysis. Past performance is no guarantee of future results. A benchmark index is not actively managed, does not have a defined investment objective, and does not incur fees or expenses. Therefore, performance of a fund will generally be less than its benchmark index. You cannot invest directly in a benchmark index.

INDEXING ISN'T FREE

Why don't I just invest in the index? Because it's not possible to invest directly in a securities index, this question really asks, "Why don't I just invest in an index ***fund***?" While there is only a small difference between the two questions, passively managed index funds have management fees that are going to reduce net investment returns.

As of May 31, 2015, the average passively managed fund in Morningstar's large blend category had a total expense ratio of 0.51%. To show that these costs add up over time, we have constructed a 35-year study that shows the difference in ending value of a portfolio that could invest in the S&P 500 (0% fee) and a portfolio invested in a S&P 500 Index fund with a fee of 0.51%. The chart below shows the impact of the fees on an initial investment of $10,000. By the end of the 35-year period, the portfolio invested in an S&P 500 Index fund with a fee would have been worth $431,145 while the one invested in the S&P 500 without a fee would have been worth $516,736. The expense ratio of 0.51% results in a dollar cost of over $85,000 over 35 years.

Difference in Portfolio Value of an S&P 500 vs. an Average S&P 500 Index Fund



Source: Morningstar® Direct℠; GWCM analysis. Past performance is no guarantee of future results. A benchmark index is not actively managed, and does not incur fees or expenses. Therefore, performance of a fund will generally be less than its benchmark index. You cannot invest directly in a benchmark index.

THE GOAL OF MANAGER SELECTION IS NOT TO SELECT THE *AVERAGE* MANAGER

This difference between an index's return and a passively managed fund's return impacts how we view an actively managed portfolio's return as well. Since one cannot invest directly in an index, then the goal is to choose an actively managed strategy that can outperform the cheapest passively managed alternative in the same asset class. The implication of this shift in perspective is that instead of having to pick a top performer out of a crowd, one simply needs to choose an average — or slightly above-average — fund in order to generate returns that exceed those of the passive option.

The chart on the next page shows how each decile of active managers within the large blend category would have fared relative to the average passively managed S&P 500 fund over the past 10 years. For example, $10,000 invested in the 10th percentile manager would've yielded a result of almost $3,000 more compared with the one invested in the average passive fund. Selecting a good active manager can generate results that dramatically outperform the benchmark.

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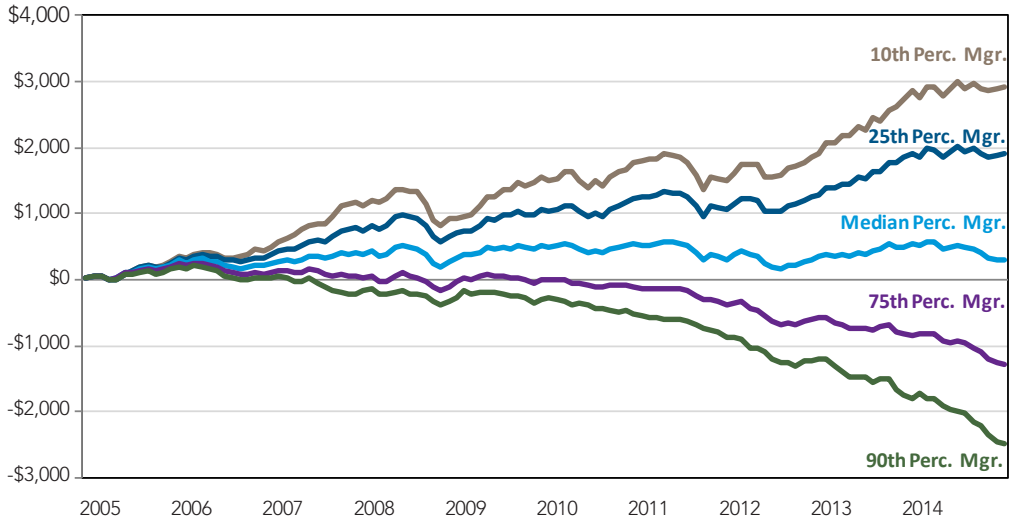
Choosing an Above-Average Manager Adds Value Above That of Passive Management



Selecting a manager in the top 10th percentile of the category resulted in 10-year outperformance of the average passive fund by $2,922 on an initial investment of $10,000.

Perrformance is shown net of fees.

Source: Morningstar® Direct℠; GWCM analysis. Past performance is no guarantee of future results.

While passive investment management has greatly outpaced active management in net flows over the past few years, there remains a strong case for the role of active management within the overall portfolio construction process. There is a cyclical nature associated with when active or passive management will be in favor, and active managers may provide downside protection during difficult market environments.

Furthermore, passive management is not free, and even these fees can add up over time. Finally, the ability to select an above-average active manager may add additional value over that of passively managed funds.

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